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Project Report

BRITISH COLUMBIA FINANCIAL REVIEW: THE ISSUE OF FEDERAL/PROVINCIAL COST SHARING

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Executive Summary—Federal/Provincial Cost Sharing

This report evaluates the impact of recent cutbacks in federal contributions to shared cost programs. It concludes that federal cutbacks cost the province $1.16 billion in 1991/92 and will cost $1.35 billion in 1992/93. Over the next decade lost federal transfers and the interest costs of borrowing to make up for it will be an estimated $32.7 billion.

The effect of the limits on federal cost sharing is not only to reduce the number of dollars available to British Columbia, but also to further increase already rapid expenditure growth in critical areas like income assistance. British Columbia taxpayers now carry much of the burden for funding these rapid increases.

The report recommends that:

- The province seek an agreement guaranteeing stability of federal cost-shared programs or increased tax room to allow the province to fund these programs itself.
- If this is not possible, consider more fundamental and far-reaching changes to the cost-sharing relationship with the federal government.
- Steps should be taken to reduce the rate of increase in program expenditures and the administrative costs, to mitigate the effects of lost federal funding.

The Issue of Federal/Provincial Cost Sharing

A. Description

1. Primary and subsidiary issues

The federal government makes large contributions to the provinces to assist them in providing various services. This is as a consequence of three factors:

- The provinces have constitutional responsibility for providing social programs. However, they do not possess the full range of revenue sources available to the federal government. The superior federal revenue-generating capacity has given it the "spending power" to fund programs in areas under provincial jurisdiction. Federal cost-sharing programs are a consequence of the use of this spending power.

- Transfers, particularly equalization, were also designed to introduce Canada-wide equity, thereby enabling the poorer provinces to provide services comparable to wealthier provinces.

- The creation of national health and social program standards has been regarded as a nation-building exercise.

Federal transfers have historically been an important component of provincial revenue structures. In B.C., 13.5% of revenues are federal transfers, although this represents a decreasing percentage of revenues for the province. This percentage does not include the tax point transfer which forms part of the Established Programs Financing arrangement, and is calculated at $1.2 billion for B.C.

The federal government is gradually reducing its share of funding for programs which have previously been cost-shared with the provincial government. The funding reduction is a major part of the federal strategy to restore federal fiscal health. While the province supports the federal government's efforts to reduce the deficit, there are concerns that this will be accomplished at the expense of the provinces. Specifically, the B.C. government feels that this should not mean disproportionately large cuts in transfers to the provinces.

Current federal plans will result in substantial further reductions in revenue to British Columbia. The projected loss in revenue from the federal government for

the fiscal year 1991/92 is $1,143.2 million. The estimated loss in fiscal 1992/93 is $1.35 billion. Much of this reduction has been through a decrease in cash transfers. This effectively transfers real program costs to the province.

The federal government drive to offload cost-sharing has also reduced the predictability of fiscal and program management options in the provincial government. Forecasting becomes more difficult when revenue sources are reduced and when new programs are unilaterally introduced by the federal government, conditional upon provincial participation. This limits the flexibility of independent provincial policy development.

2. Entities involved

The reduction in federal funding affects the larger transfers through the Established Programs Financing Act (EPF), covering health care and post-secondary education, and the Canada Assistance Plan, covering income assistance and related social services. It also impacts on a number of smaller transfers (for such services as housing, manpower training and drought relief). The specific entities that are affected by the federal offloading or reduced federal government participation include:

- Ministry of Aboriginal Affairs
- Ministry of Advanced Education, Training and Technology
- Ministry of Agriculture, Fisheries and Food
- Ministry of Attorney General and Solicitor General
- Ministry of Economic Development, Small Business and Trade
- Ministry of Education
- Ministry of Energy, Mines and Petroleum Resources
- Ministry of Forests
- Ministry of Health
- Ministry of Municipal Affairs, Recreation and Housing
- Ministry of Social Services
- Ministry of Tourism & Culture

3. Related issues

The issue of reduced federal transfers is part of a broad series of issues relating to fiscal federalism. Included in this topic are the matters of improved policy coordination, and government spending controls. These issues are being merged with efforts to address constitutional problems. Some of the federal proposals, such as the transfer of responsibility for manpower programs, may involve additional offloading.

B. Government policies

Government policies in the area of federal/provincial cost-sharing tend to be strongly influenced by the federal government. In a number of cases, federal influence on program design has, over the years, made these programs even more expensive to operate. With respect to Established Programs Financing (EPF), there is no formal federal-provincial agreement, as authority resides in the federal Act. This legislation, therefore, can be modified or terminated at the pleasure of the federal government.

The Canada Assistance Plan (CAP) Act since the mid-1960s has provided for agreements which outline the terms and conditions relating to the transfers pertaining to income assistance and other social services for persons "in need". However, the 1990 federal budget unilaterally changed the terms of this contractual arrangement. The B.C. government appealed the federal action on the grounds that it violated a contractual agreement. The Supreme Court of Canada found in favour of the federal government on the basis that the federal government's right to manage its fiscal affairs (parliamentary sovereignty) had more weight than a federal-provincial contract.

At the same time that it is reducing social services cost-sharing, it is also refusing to take the responsibility for Indians not living on reserved lands. Specifically, federal payments for Indian children in care declined 29% in 1991/92, over 1990/91.

C. Government practices

The EPF arrangement was instituted in 1977. This "block grant" replaced other cost-sharing mechanisms for financing medical care, hospital insurance and post-secondary education. The EPF contribution is calculated as a per capita amount (equal in value across the country) and was increased annually in accordance with the growth in the national economy. This amount is subdivided into a cash transfer and a tax component. The tax component resulted from the negotiations conducted prior to the inception of the arrangement. Essentially, the federal government withdrew from a portion of the personal and corporate income tax bases. The tax room created was then occupied by the provinces.

A calculation is made each year as to the current value of the tax point transfer. This amount is deducted from the total potential EPF contribution which has been calculated according to the growth formula. The balance is made up in cash payments to the province.

The CAP has shared approved costs on a 50:50 basis. However, the 1990 federal budget placed a limit of 5% per annum on the growth of those CAP transfers to provinces not receiving equalization. These restrictions were extended in the 1991 budget to 1994/95. It is anticipated that the extension could be indefinite.

The federal government has also, over the last few years, restrained its expenditures in a whole range of smaller federal transfers, and in the federal government equalization program.

It should be noted that in many cases new and now very expensive programs were set up in the first place in anticipation of federal cost-sharing.

D. Findings and conclusions

1. A financial overview

The effect on British Columbia of federal transfer restraint over the next decade will be enormous. Including the interest cost of borrowing to make up for the shortfall, the effect is estimated at $32.7 billion. For the 1991/92 fiscal year, alone, the impact will be $1.14 billion. Exhibit I outlines the estimated total impact of federal offloading on BC.

Exhibit I
Total impact of federal offloading ($ millions)

Program	1990-91	1991-92	1992-93
Established Programs Financing			
Eliminating two points of tax transfer	191.4	209.0	221.3
6/5 applied to PSE component	49.1	53.7	56.8
Escalator reductions	275.6	378.6	483.1
Growth freeze	140.9	249.0	276.1
Canada Assistance Plan			
Cap on growth	41.0	145.0	298.0
Other Programs:			
GRIP/NISA	—	2.1	2.1
Crop insurance	2.0	2.1	2.4
Drought relief	5.0	4.0	4.0
Unemployment insurance	45.0	60.0	60.0
Manpower agreements	26.6	28.3	32.3
RCMP Contract	19.7	20.5	23.0
Young Offenders	5.0	9.9	12.6
Housing	0.3	1.5	3.2
Total Impact	**$801.60**	**$1,163.70**	**$1,348.20**

The federal government is clearly seeking to offload a significant amount of program costs onto the provinces, by various direct and indirect means For example, in the latest federal Expenditure Control Plan, provinces are expected to absorb 37% of the cost of federal restraint over the next five years, despite the fact that transfers account for only 20% of federal spending. As a result, the imbalance between provincial program responsibilities and actual revenue capabilities is becoming much more pronounced. Provincial expenditures have been growing much more rapidly than federal expenditures for many years and it is expected that this trend will continue.

The impact on EPF, in particular, has been quite significant in the last decade. The EPF arrangement has been subjected to a progressive series of federal actions which has reduced federal contributions below the original formula:

- In 1982/83, a cut was made to the EPF transfer equal in value to two personal income tax points (2% of basic federal tax).

- The post-secondary education portion of the transfer was limited to 6% growth in 1983/84 and 5% in 1984/85, rather than the growth provided under the funding formula.

- In 1986/87, the annual escalator determining the growth of the per capita transfer to the province was reduced to national economic growth minus 2%.

- The 1989 federal budget announced that commencing in 1990/91 the annual escalator would be reduced by a further 1%.

- The 1990 budget exacerbated the situation with a two year freeze in the per capita growth of EPF transfer.

- The 1991 budget extended the freeze an additional three years to 1994/95. The five year impact on B.C. of the pre-freeze measures and the five year freeze is $5,119.60 million.

- In 1991/92 these reductions resulted in a federal contribution $890 million lower than would have been received under the original formula. It also meant that the federal EPF contribution to B.C. spending on health care and post-secondary education had dropped from 50% to 41.5%.

Since 1986/87, the federal share of provincial spending on health care and post-secondary education has been declining. At one time, the federal contribution offset half of the cost of this programming. It will only cover 37% in the first few years of this decade and by the end of the decade it is expected that the contribution will decrease to 27%. Furthermore, given the design of the EPF, the cash portion of the transfer will eventually disappear, probably in the next decade.

This cash transfer is the only portion that is actually counted as a provincial budgetary contribution. Thus, when the cash transfer disappears, it would be as if the EPF agreement has been terminated for annual budgetary purposes. The federal government has realized that this would restrict its "funding lever" to exercise influence over the programs. Consequently, the 1991 budget announced a federal legislative intention to use equalization and the Canada Assistance Plan to exact funding penalties for non-compliance with federal standards. So while Ottawa's contribution to total costs declines, it seeks to preserve its impact on how service operates.

2. Federal cost-sharing with the ministries—a few examples

Federal cost-sharing is an intrinsic component of many programs. Offloading costs to the province will impact on a number of ministries and a wider number of programs. A sampling of these are identified below.

a) Ministry of Social Services

Federal/provincial agreements within the Ministry of Social Services are managed through the Federal/Provincial Agreements Division. This Division has two objectives:

- Ensure the maximum revenues are obtained through the Ministry's federal/provincial agreements by negotiating favourable agreements and ensuring new directions, policies, procedures and legislation are capitalized on in these agreements.

- Promote provincial and ministerial priorities with respect to social policy development in the federal/provincial arena.

The Division manages three major agreements. They are the Canada Assistance Plan (CAP), discussed previously, a Memorandum of Understanding respecting Indian child welfare valued at $16 million and an Employment and Training Agreement for social assistance recipients, a cost-matching program of $28 million. These agreements were recently renegotiated for a five year period.

There are three major issues which plague the administration of these agreements by this Division.:

- **Child poverty**—The presence of child poverty in Canada has fluctuated over the years, but it has never dropped below a national level of 15%. Federal/provincial cash benefit payments on behalf of children are in the neighbourhood of $14 billion annually, with the federal government contributing 90% of this. However, much of this money finds its way to middle income families as a result of poorly targeted programs such as family allowance and the child

care expense deduction. The distribution of these monies is an issue which must be resolved and rationalized in light of the broader social objectives. The federal government has greatly reduced child-related support (by $35 billion) over the last few years and political pressures may demand that the province compensate for these losses.

- **CAP ceiling**—This issue has been discussed elsewhere in this paper. Of particular note, however, is the fact that B.C. received $39.6 million in overpayments when the court action was taken by the B.C. government. The federal government proposed the following payback provisions for the 1990/91 overpayment:

November 1991:	$13.5 million
December 1991:	$13.5 million
January 1992:	Balance owing

The payback is effected through reducing the provincial monthly revenue advance.

Since CAP also applies to municipalities, the province must decide how to pass on the federal cuts. A recommended alternative is that the province claim and pay revenue on the basis of the 1989/90 agreement plus 5%. This will put the municipalities in the same position as the province but may affect municipal requests for future provincial funding.

- **Federal offloading of social services to Indians**—The fiscal arrangement between the Ministry of Social Services and the federal Department of Indian and Northern Affairs (INAC) is set out in an unsigned Memorandum of Understanding dated September 1986. The province is to provide child protection services on behalf of the status Indian children in need of protection if their parents are living on a reserve or, if not on a reserve, are receiving income assistance. INAC assumes the costs for a status Indian child in provincial care. The federal government, however, has indicated that it intends to cease paying for the costs of child welfare services to status Indians living off reserved lands. The revenue loss for this initiative would be $6-$8 million.

Offloading is also occurring in the health care services. The federal government is withdrawing coverage for status Indians living off the reserve if they are receiving income assistance and if they are eligible for the Ministry of Social Services health care coverage. The B.C. coverage is far less generous then the federal

coverage and has caused concern with clients and with native organizations.

The federal government has also refused to pay for uninsured medical/health benefits provided to non-status Indians residing on reserves. The increased Ministry expenditures here could be offset by INAC fully reimbursing the province for all services provided on reserve. Currently, the Ministry delivers $34.5 million worth of programming on reserves.

The foregoing situation must be rationalized. The province has three options:

- Negotiate a clear division of responsibilities.
- Await the outcome of the larger self-government and land claims issues.
- Extend provincial services where requested on reserves without federal reimbursement. This approach is costly and is also precedent setting.

Unfortunately for the province, the federal reduction in cost-sharing falls upon those programs already having some of the steepest annual cost increases. The best example is social services. Over the five years from 1989/90 to 1993/94 total budgeted expenditures will increase 69%; or a year-over-year average increase of 17.3%. But the net cost to the province will increase 95.8%; or a year-over-year average of 24%. The difference is because of lost federal funding. In short, under the combined effect of both growing demand and a diminishing federal share, the cost of social services to British Columbia is increasing at almost 25% a year.

b) Ministry of Aboriginal Affairs

The major federal/provincial issue that directly affects this ministry is the settlement of land claims. The Province maintains that all compensation costs associated with negotiated claims are the responsibility of the federal government. Preliminary estimates for these costs are between $4 and $15 billion. The federal government indicates that the Province should assume a portion of this liability. The Province has publicly indicated its intention to pay its "fair share". To date, the federal government has proposed a 70:30 federal/provincial contribution. This would in reality be closer to a 50:50 division as the Province must provide the land and resource costs. In Saskatchewan, the final federal/provincial split for the settlement of the land claims was somewhere between 49:51 and 70:30.

The Ministry must balance the federal offloading of costs and programs with the assurance that the federal government will not abrogate its constitutional, jurisdictional and financial responsibilities for aboriginal peoples.

c) Ministry of Economic Development, Small Business and Trade

The major impact of federal-provincial cost-sharing in this ministry flows through the Economic and Regional Development Agreements (ERDA). While they do not represent examples of offloading, they do provide examples where federal funding support to federal programs has been reduced. This reduction may require greater provincial funding to offset this loss.

The umbrella agreement, signed in 1984 for a term of ten years, provides a federal/provincial framework for funding. There are eight subsidiary agreements which represent a joint commitment to invest $600 million over five years. In phase 1 specific initiatives worth $575 million were negotiated for forestry, industrial development, small business, agriculture/food, tourism, science and technology and minerals.

Phase 1 has expired and the second phase, called Western Economic Partnership Agreements (WEPA), provides $60 million to each of the four western provinces, subject to the availability of matching provincial funds. The federal government requested that $30 million be allocated to federal priorities and $30 million to provincial priorities. The federal priorities are forestry, communication, tourism and minerals.

The Phase 1 programs that were administered through the then Ministry of Development, Trade and Tourism are:

- Industrial Development SubAgreement (IDA)—$125 million
- Small Business Incentives SubAgreement (SBISA)—$50 million
- Tourist Industry Development SubAgreement (TDA)—$30 million

These agreements provided the following contributions:

Exhibit II
ERDA contributions to the Ministry of Development,Trade and Tourism(1985-90) ($ millions)

Program	Funds Approved	Funds Disbursed	Projects Undertaken	Direct Jobs Created/Maint.
IDA	40.82	32.02	21	1972
SBISA	23.99	17.64	284	4754
TDA	17.6	15.48	43	3584
TOTAL ERDA	82.41	65.14	348	10310

Each Agreement provides for a number of programs. Within the Industrial Development Agreement, five programs are provided for:

- Resource Industries Modernization Program—Administered by Western Economic Diversification (WD), this $3.5 million program assists resource industries in the acquisition, adaptation and application of technology to improve competitive performance and enhance market access. Minimum eligible costs are $2 million.

- Resource Industries Value-Added Program—This $15 million program, administered by the Ministry, assists resource industries to add further value to raw products by expanding or acquiring plant facilities, machinery or equipment. Assistance is provided through low interest loans, with flexible repayment terms. Minimum eligible costs are $2 million.

- Industrial Diversification Program—This $60 million program, administered jointly by the Ministry and WD, assists major manufacturing projects in strategic sectors and encourages new companies and industries which have comparative advantages. The program provides flexible financing for minimum amounts of $2 million.

- Institutional Support Program—This $12 million program assists technological or innovation oriented institutions to acquire capital equipment required to upgrade the level and scope of services provided to the industrial community. Eligible applicants are research organizations and institutions concerned with technology transfer. The program provides flexible financing to eligible applicants.

- Opportunity Identification & Assessment Program—This $2 million program provides funds for studies, research or technical evaluations and eligible applicants are normally the federal and provincial governments.

The Small Business Incentives Agreement is targeted to small and medium businesses and is managed jointly by federal and provincial governments, with program delivery administered through the Ministry. The Small Business Incentive Program provides low interest repayable loans up to $500,000, with specific financing, equity, security and repayment terms. The program is targeted to projects involving manufacturing, processing, advanced technology manufacturing, aquaculture and some service sector activities vital to manufacturing and processing.

The Tourist Industry Development Agreement includes three programs:

- International Market Development Program—This $6.25 million program administered by Industry, Science and Technology Canada (ISTC) provides assistance for the development of international marketing for B.C. tourism products in the international marketplace.

- Product Development Program—This $20 million program, administered by the Ministry, is focused on the development of destination resorts, events and attractions. It is intended to broaden the appeal of B.C, in the international tourist community. The minimum project size is $150,000 to $1 million, depending on the project.

- Tourism Industry Support—A $3.5 million program designed to upgrade skills, conduct research and broaden the knowledge base in the industry.

3. The federal perspective

The federal government is faced with its own severe debt load. The need to pay greater amounts of interest is severely constraining federal expenditure options.

The federal government maintains that the EPF is growing each year due to the tax transfer. The entitlement for the provinces is growing as it grows with population growth and is paid on a per capita basis. However, the cash component is declining.

The federal government insists that the tax point transfer be counted as part of the federal contribution to health care and post-secondary education. Federal officials say it was part of an arrangement negotiated many years ago. Consequently the provinces, having negotiated it, cannot now pretend the tax transfer did not exist. (The tax transfer, however, is not counted in estimates as either a federal expenditure or a provincial revenue.) The federal government has, incidentally, recovered all the tax points it surrendered to the provinces in 1977 through two federal surtaxes. Tax reform in the late 1980s reduced provincial revenues but the two federal surtaxes prevented this from occurring at the federal level. The issue of whether transferred tax points should be considered as part of the EPF transfer is, therefore, still open to debate.

To date, the federal government has not acknowledged it is dismantling heretofore successful joint federal-provincial funding initiatives for social programming. Nor has it provided advice to the provinces as to how they can meet the rising costs of social services. There is some implication that the provinces should reduce the level of services currently provided, or consider the extensive redesign of programs. However, the imposition of federal national standards makes this difficult.

The federal Department of Finance is currently trying to interest the provinces in engaging in a federal-provincial major transfer reform exercise. This effort, however, does not address offloading or the related constitutional changes and the possible transfer of additional revenue room to the provinces.

E. Recommendations

1. Mitigating strategies

The two goals of managing the federal deficit and ensuring satisfactory funding levels for major social programs are in apparent conflict. From the provincial perspective, a resolution of this conflict must begin with the premise that the current federal-provincial fiscal imbalance is the product of federal fiscal policy. In essence, the provinces should not let the size of the federal debt compel them into giving blanket approval for the continuation of the imbalance.

The provinces must strive to ensure that the access to revenues, whether they be federal transfers or provincially sourced funds, equates generally to the actual costs of the programs as delivered. If federal financial support has been permanently reduced, these program costs must be reduced accordingly. Obviously, the achievement of this objective can be targeted at increasing revenues or reducing costs in the delivery of the programs. In addressing the former, there are three broad options available to B.C.:

- Agree that a strong federal role in funding social programs should continue and cooperatively work on a fiscal plan, addressing both revenue and expenditure measures, to enable the federal government to meet its expenditure obligations to the programs, while managing its deficit.

- Accept the federal withdrawal from jointly funded social services programming and accordingly reconfigure the revenue structure to provide the provinces with the tax room required to deliver the services. This approach may necessitate radical changes to the revenue structure and could extend to permitting the provinces to assume the entire income tax function.

- Reconfigure the transfer system so that the federal government becomes solely responsible for funding certain program areas which are now jointly funded. The provinces would assume responsibility for funding in other areas. Revenue structures would have to be adjusted to reflect the reconfiguration.

The present imbalance will have drastic consequences for the ongoing management of social programming in the province. The provinces, individually or collectively,

must seek to redress the imbalance. The constitutional limitation on levying taxes limits the provincial ability to generate revenue. Unless the level or structure of social programming is modified, the province must have increased federal transfers, increased tax room or reduced programming costs in other areas. Clearly, further discussion with the federal government is necessary.

There have been some suggestions that the province should seek to negotiate a bilateral agreement with the federal government that ensures provincial policy flexibility, improves predictability of funding and permits stable and predictable access to federal monies, while meeting provincial commitments within national programs. If this is not possible, the province should consider more fundamental and far-reaching modifications to its cost-sharing relationship with the federal government; and gradual reduction of dependency on federal dollars. This can only be done by extensive program redesign, leading to lower costs.

One possible alternative is the better coordination of federal and provincial programs in overlapping fields like income assistance. As noted in our paper on revenue, consideration of an integrated, national income support program on the lines of a negative income tax could, if properly designed, reduce work disincentives. It could also reduce administrative overhead and improve the targeting of support on those most in need. See the discussion of this concept in: **Income Maintenance, Work Effort and the Canadian Mincome Experience,** Economic Council of Canada, Ottawa, 1991, by Derek Hum and Wayne Simpson.

Better administration of income assistance could reduce costs resulting from overpayments and fraud.

2. Further study

Further study is needed to identify possible program expenditure reductions. The province must examine avenues for using the current dollars more efficiently. The Auditor-General has recently completed Value-for-Money Audits with respect to the federal/provincial cost-sharing agreements. When published, the findings of these audits may warrant significant program design and delivery changes.

Constitutional reforms may impact on social programs. The province must continue to monitor these discussions to determine how constitutional modifications will affect social programming costs and the transfer mechanisms currently in place. If CAP is to remain in force, it will continue to be subject to unilateral action by the federal government. Furthermore, the current constitutional structure will see that there are no new national cost-shared agreements unless they are approved by seven provinces representing 50% of the population.

Finally, the federal government is considering transferring responsibility for a number of functions to the provinces. The impact of this must be examined closely, including the attendant cost implications. Housing and culture are two areas which are targeted to shift to provincial jurisdiction.

In summary, British Columbia is contributing to the reduction of the federal deficit by the continued loss of federal dollars; and this is intensifying the impact of provincial imbalances between revenue and expenditure. In the long run the strategic options are either an agreement with the federal government which provides security of cost-sharing levels or a decision to make the province less and less reliant on this source of funding.